Supreme Court of the United States

OCTOBER TERM, 1923.

No. 352.

THE PEOPLE OF THE STATE OF NEW YORK,
Appellant,

—against—

LOUIS JERSAWIT, as Trustee in Bankruptcy of AJAX DRESS CO., INC.,
Appellee.

BRIEF FOR APPELLEE.

MOSES & SINGER,
Attorneys for Appellee,
Office & Post Office Address,
No. 55 Liberty Street,
Borough of Manhattan,
City of New York.

HENRY B. SINGER,
Of Counsel.

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BRIEF FOR APPELLEE.

POINT I.

THE FRANCHISE TAX UNDER SECTION 209 OF THE TAX LAW OF THE STATE OF NEW YORK IS NOT A TAX FOR THE PRIVILEGE OF BEING OR CONTINUING TO BE A CORPORATION. IT IS A TAX FOR THE PRIVILEGE OF EXERCISING A FRANCHISE, AND SHOULD THEREFORE BE APPORTIONED WITH RESPECT TO THE LENGTH OF TIME THE PRIVILEGE IS EXERCISED.

Section 209 of the New York Tax Law, so far as material for our purposes, reads as follows:

> "*Franchise Tax on Corporations based on Net Income*: For the privilege of exercising

> its franchise in this state in a corporate or organized capacity, every domestic corporation, and for the privilege of doing business in this state, every foreign corporation * * * shall annually pay in advance for the year beginning November 1st next succeeding the first day of July in each and every year an annual franchise tax to be computed by the tax commission upon the basis of its entire net income for its fiscal or calendar year next preceding, upon which such corporation is required to pay a tax to the United States,".

In the instant case the tax claimed by the State Tax Department of New York is for the year beginning November 1st, 1920, and ending October 31st, 1921, and under the statute computed on the basis of the entire net income of the corporation for the year next preceding November 1st, 1920. The corporation, however, went into bankruptcy on December 22nd, 1920, having exercised its franchise for a little less than two months during the year for which the tax is sought to be imposed.

The controversy, therefore, is whether or not under the statute the corporation was required to pay the tax for the entire year or merely for that portion of the year during which it exercised its franchise. The District Court and the Circuit Court of Appeals have both held that the tax should be apportioned.

In re Ajax Dress Co., Inc., 290 Fed. 950.

Concededly the Section in dispute is silent on the question at issue. The inference, however, that the tax should be apportioned, is not to be denied. The wording of the statute can permit of but one

construction—the construction adopted by the decisions in this state to the effect that *a tax imposed thereunder, being one for the privilege of exercising a franchise and not for the privilege of possessing a franchise must be apportioned with respect to the length of time that the franchise is exercised.*

That view finds support in a leading New York case. *People ex rel Mutual Trust Co. vs. Miller*, 177 N. Y. 51, which though decided under another section of the Tax Law—section 187-a (now 188) of the Tax Law of the State of New York—nevertheless states the general principles applicable to our case. In the *Miller* case the Tax Department of the State of New York sought to exact a franchise tax for an entire year where the Trust Company had only been in existence for six days of the year in question. The company argued that since it had carried on business for only six days during the year for which it was sought to be taxed, the tax should be apportioned with respect to the length of time that it exercised its corporate franchise. This contention was sustained by the Court of Appeals. We quote from the decision of Vann, J., page 54, as follows:

> "The tax under consideration is not imposed upon property, but upon a privilege. *It is not imposed upon the privilege of becoming a corporation, for that would be an organization tax, payable but once for the entire period of corporate existence.* It is imposed 'for the privilege of exercising' the corporate franchise, and is measured by the value of the investment made and used in carrying on the corporate business. *It is an 'annual' tax, imposed 'annually,' as the statute expressly provides, for the privilege of exercising, not of possessing a*

corporate franchise. This privilege was used by the relator for only six days during the fiscal year in question. It could not exercise its franchise for the entire year, because the state did not bring it into existence until the year had nearly expired. *The consideration for the tax is the privilege of carrying on business, yet the relator, according to the requirement of the comptroller, was compelled to pay for a privilege that it did not have and could not exercise during the greater part of the period for which the tax was laid. It used the privilege for only six days, but it is taxed for using it 365 days, during 359 of which it did no business and enjoyed no privilege.* An annual tax is a tax reckoned by the year the same as annual rent or annual interest. An 'annual' tax imposed 'annually,' means a tax that is imposed once a year, computed by the year. If a trust company does not commence business until six days before the fiscal year ends, OR IF IT CEASES TO DO BUSINESS SIX DAYS AFTER THE YEAR BEGINS, THE TAX FOR DOING BUSINESS BY THE YEAR REQUIRES APPORTIONMENT. *While the legislature did not so provide in express terms, it is a fair and reasonable implication from the words used that such was its intention.* When by Section 182 of the Tax Law it imposed an annual tax payable annually upon every corporation of a certain class, to be computed upon the basis of the amount of its capital stock 'employed within the state' during the year, it did not say expressly that the assessment should be determined by the *average* amount of capital so employed, but we held that this was what was necessarily meant. * * *"

The Attorney General argues that the tax under Section 209 is one "for the privilege of continuing to exercise the corporate franchise." This phrase quoted from the Attorney General's Point I is obviously taken from the case of *New Jersey vs. Anderson*, 203 U. S. 483, cited by the Attorney General on page 12 of his brief. On page 490 of the opinion the Court, in discussing the tax there in question, says:

> "We think the weight of judicial decision in that state (New Jersey) favors the view that this is a tax imposed upon the right of the corporation *to continue to be a corporation.*"

Immediately below that on page 490, the Court calls attention to the fact that the tax under discussion is denominated by the New Jersey Statute as a "license tax," that is, a tax for the privilege of being a corporation. That being so, *New Jersey vs. Anderson* (*supra*) is obviously not in point in a discussion of Section 209 of the Tax Law of the State of New York which, to repeat, imposes a tax *for the privilege of exercising a franchise.* The Attorney General is talking of a license tax when he talks of the privilege of continuing. In such a case you pay the tax for a license—a thing that is not divisible. By the express terms, however, of the New York Statute and by the weight of judicial decision in this state, construing that statute, the tax is imposed for the privilege of exercising or using a franchise. *People ex rel Mutual Trust Co. vs. Miller*, 177 N. Y. 51 (*supra*), and *People ex rel L. & N. Y. R. R. Co. vs. Sohmer*, 217 N. Y. 443. Whether under the New Jersey Statute you use what you have bought, makes no difference. But when we pay for the use of the thing, as you do

under Section 209 (*supra*), how can we be consistent and say "true, the tax is imposed for the use of a thing, but whether or not you use it makes no difference. You must pay the tax in any event."

Such a view is favored neither in logic nor in Justice.

THE CHANGES IN THE WORDING OF THE STATUTE UNDER DISCUSSION HAVE WORKED SOME CHANGES IN EFFECT WITHOUT HOWEVER NECESSITATING A CHANGE IN THE RESULT OF THE INSTANT CASE.

The general principles applicable to our question remain unchanged. It is argued that Section 182 of the Tax law of the State of New York has been changed to the extent of nullifying entirely the effect of the case of *People ex rel Mutual Trust Co. vs. Miller,* 177 N. Y. 51. It is further argued that the case of *People ex rel N. Y. C. & H. R. R. R. Co. vs. Gaus*, 200 N. Y. 328, decided under the amended Section 182 has expressly overruled *People ex rel Mutual Trust Co. vs. Miller* (*supra*). Both of these arguments state only half truths.

The *Miller* case is decided under Section 187-a (now Section 188) of the Tax Law. That section reads:

> "Every Trust Company * * * shall pay to the state annually for the privilege of *exercising its corporate franchise* an annual tax which shall be equal to 1% on the amount of its capital stock, surplus and undivided profits."

Under this section the tax apparently is paid at the end of the year and is computed on the basis of the capital stock, surplus and undivided profits

used by the Trust Company during that year. That is to say, the tax is in payment of a privilege already exercised and is computed on the basis of the amount of capital employed during the period when the privilege was so exercised. We emphasize these facts. As will be seen later, they are essential in arriving at the real significance of the changes made in the Tax Law.

The *Gaus* case is decided under Section 182 of the Tax Law, which reads:

> "For the privilege of *exercising its corporate franchise* in this state every domestic corporation * * * shall pay to the State Treasurer annually in advance an annual tax to be computed upon the basis of the amount of its capital stock employed during the preceding year within this state and upon each dollar of su amount."

Under this section the tax is paid for a privilege to be exercised during the year succeeding the date the tax is payable, but is computed on the basis of capital stock employed during the preceding year. That is the important distinction between the two sections and the two cases decided under each of these sections respectively. Indeed this very difference is suggested in the *Gaus* case (see pages 330, 331 of the opinion) where the Court says:

> "After our decision (referring to the *Miller* case), however, the Legislature amended Section 182 of the Tax Law so as to provide that the tax should be paid in advance. The amendment changed the character of the tax as to corporations embraced within that Section *from a payment for past privileges already en-*

joyed to a payment for privileges to be enjoyed during the following year."

The Attorney General emphasizes this quotation on page 15 of his brief by means of italics. He emphasizes and is impressed mainly with the fact that the law has somehow been changed. The significance of the change, however, has escaped him. He has accepted the *Gaus* decision as a blanket reversal of everything in the *Miller* decision. That, however, is clearly not the case.

It is important to note that in the *Miller* case the privilege for which the tax was levied was exercised during the very year taken as a basis for the computation of the tax. Because of that, but one method of apportionment appears possible. An analysis, however, of our problem shows that we are permitted to make a double apportionment: (1) an apportionment with respect to the computation of the tax or the value of the franchise, and (2) an apportionment with respect to the length of time the franchise is exercised. For example, take a state of facts parallel with those in the *Miller* case. Let us assume that a corporation employs a capital stock of $50,000 for the first three months of a year and then increases its capital stock to $100,000 during the second quarter of the year, so that for the second quarter of the year it employs a capital stock of $100,000. Let us assume further that this corporation goes out of business at the end of the half year. Problem: what is the tax to be imposed for the exercise of its franchise during that half year? Which of our two methods shall we apply in computing the tax to be paid by this corporation? The *Miller* case would seem to indicate that the tax to be paid by the corporation is to be computed on the basis of the average amount of capital stock used

during the time the corporation exercised its franchise; that is, the apportionment of the tax takes place at the moment the tax is computed and in a single process. That does not seem to us to be the logical method. Rather it would seem that the tax should be computed on the basis of the entire amount of capital stock used during the entire year without averaging. Then once the tax is so computed for the entire year the apportionment should take place. If the corporation has used its franchise for but half a year, the tax should be half of the figure so computed. That method seems to have been intended by the Legislature. The only apportionment logically permitted under the statute is an apportionment with respect to the length of time the franchise was used, and that is the only apportionment we should make. In fact, we believe that it is because of the misconception on the part of the Courts in construing the tax statutes that the Legislature amended the tax sections under discussion herein so as to indicate clearly that in computing a tax, *in arriving at the value of the use of a franchise*, we should not average or apportion with respect to the length of time the capital stock, the basis of the computation, was employed. Apportionment should take place thereafter. Once having arrived at the figure to be paid for the privilege of using a franchise for the year, it is then a simple matter to compute how much of that figure is to be paid, depending upon how long the franchise is used.

That distinction is not apparent in the *Miller* case, for the very obvious reason that whether we employ the one method of determining the tax or the other, the result arrived at is the same; the reason for that being that the amount of capital stock remained unchanged, and the length of time

during which the capital stock was employed and the length of time during which the franchise was used were identical.

When, however, we come to consider the amendments made in Section 182 of the Tax Statute, and the *Gaus* case decided thereunder, the distinction between the two methods of apportionment becomes quite clear. Due to the confusion existing theretofore, the Legislature by its amendment in making the tax payable in advance indicated that the only method of apportionment was to be the second one, to wit, an apportionment with respect to the length of time the franchise was used—the only logical apportionment under the statute before and after the amendment. And that is what the *Gaus* case decided (and we submit that is the only thing argued and decided in the *Gaus* case), viz., that in computing the tax we are not permitted to average or apportion. At that point we must take as the basis of our computation the entire amount of capital stock used during the preceding year, whether used for one day or for the entire year. The other question, whether or not the tax was to be apportioned with respect to the length of time the privilege was used, was not at issue, was not argued nor even considered in the *Gaus* case. The conclusion in the *Gaus* case is obviously correct and undoubtedly interprets the changes in the statute and gives effect to the Legislative intention in making such changes.

We quarrel with but one phrase in the *Gaus* case used, we believe, inadvertently by the Court. The Court says on pages 330 and 331 of the opinion: "The amendment changed the character of the tax." That is not true. Under the previous statute the tax was imposed "for the privilege of exercising a franchise" and under the amended

statute the tax is imposed for exactly the same privilege. The character of the tax was not changed. It was only the method of computation, the method of arriving at the value of the annual tax that was changed. The nature of the tax remained the same. And so far as the character of the tax is concerned, the words of the *Miller* case are as applicable today as they were when that case was decided. It is a tax "not imposed upon property but upon a privilege. *It is not imposed upon the privilege of becoming a corporation, for that would be an organization tax payable but once for the entire period of corporate existence. It is imposed for the privilege of exercising a corporate franchise. * * * It is an 'annual' tax imposed 'annually' as the statute expressly provides for the privilege of exercising not of possessing a corporate franchise*" (page 54 of the opinion). And the conclusion is that if the privilege is exercised but for a portion of the year, the corporation should be required to pay for only that portion of the year during which it makes use of the privilege.

As was said above, the amended statute, like the previous statute, is silent on the precise point at issue. The Attorney General's contention that the changes in the statute necessitate an entire change in result, is too simple to be true. It leaves too many things unexplained. Had the Legislature sought to make a change in the nature of the tax what was there to prevent it from changing the words "for the privilege of exercising its corporate franchise."

The phrase "for the privilege of exercising a franchise" had under the *Miller* case (*supra*) and under the *Sohmer* case (*supra*) assumed a very definite meaning, one contrary to that urged by the Attorney General. Can it, in the face of that, be

argued that in using the identical words the Legislature intended a change in the character of the tax? Furthermore, what was there to prevent the Legislature from saying in so many words that the tax should in no wise be apportioned. The answer is compelling. The Legislature did not intend to exact a tax for the privilege of exercising a franchise whether or not the franchise was exercised. Its intention in making the change was the one indicated above, that in computing the tax, in arriving at the annual charge to be made, there was to be no averaging or apportioning. It did away with whatever confusion had crept into the decisions in computing the tax. That change and that change alone is the one the Legislature made.

Appellee further urges upon the Court this well established principle, that where in a tax statute the Legislature leaves some doubt for the Court to resolve, that immediately creates a presumption in favor of the citizen and against the state. Statutes are always thuswise strictly construed.

> *People ex rel Mutual Trust Co. vs. Miller* (*supra*).

As was said in that case:

> "A statute which levies a tax is to be construed most strongly against the government and in favor of the citizen. The government takes nothing but what is given by the clear import of the words used and a well founded doubt as to the meaning of the Act defeats the tax."

The Attorney General calls attention to one other change in the statute which to him seems to change

the nature of the tax. Whereas previously the law read:

> "for the privilege of doing business or exercising its corporate franchise"

it now reads:

> "for the privilege of exercising its corporate franchise."

The words "for the privilege of doing business" are omitted. From this change the Attorney General can derive but one conclusion, namely, that the Legislature intended to change the nature of the tax. That however is not a necessary consequence. In fact the explanation is much simpler. The intention manifestly was merely to get rid of superfluous words. The terms "doing business" and "exercising a franchise" are synonymous and have so been construed.

> *People ex rel L. & N. Y. R. R. Co. vs. Sohmer*, 217 N. Y. 443;
> *People ex rel Mutual Trust Co. vs. Miller*, 177 N. Y. 51.

We have twice before quoted words from the *Miller* case which define the meaning of the phrase "for the privilege of exercising a franchise," to show that exercising a franchise does not mean merely being a corporation. The *Sohmer* case establishes beyond question that the phrases "doing business" and "exercising a franchise" are identical in meaning. That case was decided under the statute before its amendment whereby the words "of doing business or" were omitted. It must be noted that the previous statute read in the alternative "for the privilege of doing business or exercising its

franchise." The *Sohmer* decision held that even though the defendant continued to be a corporation in this state it was not taxable because it was not doing business in this state. If the Attorney General is correct in his contention that exercising a franchise means merely being a corporation, then what difference did it make in the *Sohmer* case whether or not the defendant was doing business in this state, since the tax there imposed on the corporation was either for the privilege of doing business or exercising its franchise. And if exercising its franchise means merely "continuing to be a corporation" then clearly the defendant should have paid the tax imposed by the statute. Since it was conceded that the corporation had continued in existence. Nor can the Attorney General argue that this point was not called to the attention of the Court. It was very emphatically called to the Court's attention as is evidenced by the dissenting opinion that takes the view urged by the Attorney General. The question was squarely before the Court and by a majority of five to two it decided "doing business" and "exercising a franchise" were synonymous terms. That being so, it follows that the Legislature with the *Miller* case and the *Sohmer* case before it adopted their construction of the phrase and omitted the words "doing business" from the amended statute as superfluous.

Another word and we are finished with this phase of the case. The Attorney General also calls attention to the fact that the statute reads differently with respect to domestic corporations and foreign corporations. The statute says "For the privilege of exercising its franchise in this state every domestic corporation, and for the privilege of doing business in this state every foreign

corporation," etc. Hence, it is argued, the terms "exercising its franchise" and "doing business" must necessarily have different meanings. The answer to that is that a foreign corporation has no franchise to exercise in this state; that the only place where it can exercise its franchise is the state where it has been granted. The only thing that a foreign corporation can do in our state is obtain the privilege of doing business here. The Legislature has indicated this difference with a fine discrimination of language.

Applying these principles and reading the statute in the light of the decisions of the highest courts in the State of New York interpreting similar language in tax statutes, the conclusion follows that the apportionment of the tax was right and fully warranted. It is not for the Court to say that the price of exercising a corporate franchise shall be the same for one day as for one year. The matter can be readily remedied by the Legislature, if such be its intention, by amending the statute so as to provide expressly against an apportionment of the tax.

POINT II.

THE COURT BELOW PROPERLY HELD THAT A CLAIM FOR INTEREST AT THE RATE OF ONE PER CENT. PER MONTH IN A BANKRUPTCY PROCEEDING IS A PENALTY AND SHOULD BE DISALLOWED.

Section 57-j of the Bankruptcy Act provides as follows:

> "Debts owing to the United States, a state, a county, a district, or a municipality as a

> penalty or forfeiture, shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transfer or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued thereon according to law."

The District Judge and the Circuit Court of Appeals held that interest on the tax should be allowed up to the date of payment, but that interest at the rate of one per cent (1%) per month amounts to a penalty and must be disallowed, under Section 57-j of the Bankruptcy Act.

There has been some conflict of authority on this question, but we submit that the reasoning in *re Ashland, Emery & Corundum Co.*, 229 Fed. 829, which was followed by both the District Judge and the Circuit Court of Appeals, is sound in principle and a proper interpretation of the Bankruptcy Act.

In that case the Court said at page 831:

> "If the charge here in controversy is to be regarded as interest, the trustee ought to pay it. Penalties, however, stand upon a different footing. It cannot be said that a penalty imposed for failure to pay a tax, is part of the original tax, in the sense that interest is. By 'interest' is ordinarily understood a charge for the use of money or damages for the detention of it. A penalty, as applied to cases of this character, means a punishment imposed for failure to make the payment on time. Section 64-a contains no provision for the payment of penalties; and I do not think

it can fairly be construed to include them, especially when, as here, the estate was in course of administration during the entire period when they accrued."

and again at page 832:

"Assuming, however, that it is, it seems to me plain, and I accordingly find, that 1% a month exceeds what is fairly required to make good loss to the state for mere delay in the payment of the tax, and as to such excess is not interest, but constitutes a penalty imposed for failure to pay promptly. The actual damages sustained by the State of New Jersey from the delay are not obscure nor difficult to estimate. What the state lost was the use of the money. Its damages therefore are the commonest form known to the law, and the most certain of estimation. They are established by statute in New Jersey for individuals at 6% per annum."

The fact that the statute itself calls it interest would not be conclusive upon the Bankruptcy Court, which has the right and power as well as the duty, to examine and decide the question for itself.

In re Ashland, Emery & Corundum Co. (*supra*);
State of New Jersey vs. Anderson, 203 U. S. 483.

In disposing of this branch of the case, the Circuit Court of Appeals did not express its views, but referred to its decision filed the same day in *re J. Menist & Co. Inc.*, 290 Fed. 947. Judge Hough

who wrote the poinion, refers to most of the cases cited by the appellant. In two of the cases, in *re Kallak,* 147 Fed. 276, and in *re Quinones,* 39 Am. Br. 320, the point that the additional interest constituted a penalty and was, therefore, not provable in a bankruptcy proceeding by reason of the provisions of Section 57-j of the Bankruptcy Act, does not seem to have been argued. The point also seems not to have been argued in *re Scheidt,* 177 Fed. 599, except that the Court makes the statement that the penalty being treated as interest, is collectible as a part of the tax itself under the Ohio law. The Circuit Court of Appeals, however, declined to concur in the implications of these cases.

As pointed out by Judge Hough in *re Menist, supra,* the case of *U. S. vs. Guest,* 143 Fed. 456, relied upon at page 27 of appellant's brief, has no application because the question there did not arise in a bankruptcy proceeding. The same may be said of the case of *Marshall vs. The People,* 254 U. S. 380, cited by appellant. The question involved in that case was one of priority. As stated by Mr. Justice Brandeis, who wrote the opinion in that case:

> "The single question is presented whether the State of New York has priority in payment out of the general assets of the debtor over other creditors whose claims are not secured by act of the parties nor accorded a preference, by reason of their nature, by the state of legislature or otherwise."

Surely, it is submitted, it is far afield to contend that this decision supports the claim of the appellant with respect to the penalty and interest.

In considering the disallowance of interest at the rate of 1%, it should be borne in mind that we are concerned only with the Bankruptcy Statute.

The conclusion, therefore, it is submitted, is inescapable that in the absence of proof of pecuniary loss by a state or municipality, interest at the rate of 1% is a penalty within the language of Section 57-j of the Bankruptcy Act, and is not an allowable claim.

POINT III.

THE DECISION AND DETERMINATION OF THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, SHOULD BE AFFIRMED WITH COSTS.

Respectfully submitted,

MOSES & SINGER,
Attorneys for Appellee.

HENRY B. SINGER,
Of Counsel.

ABRAHAM H. RUBENSTEIN,
of the City of New York,
with him on the brief.

The Alpert Press, 138 Livingston St., Brooklyn, N. Y. Tel. Main 1058-1059